Corporate Governance of Banks in Eurasia

A POLICY BRIEF

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Policy Brief on Corporate Governance of Banks in Eurasia

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The *Policy Brief on Corporate Governance of Banks in Eurasia* identifies key corporate governance challenges affecting Eurasian banks and the banking sector, and recommendations to address them. Its purpose is to support policy-makers, banking supervisors, capital market regulators, stock exchanges, banking industry associations, institutes of directors, and, last but not least, banks in the Eurasian region. While reflecting well-known international standards such as the *OECD Principles of Corporate Governance* and the Basel Committee's guidance, *Enhancing Corporate Governance for Banking Organisations*, its recommendations are developed in the Eurasian context.

Given the dominant role that banks play in regional finance, the Eurasian Roundtable on Corporate Governance identified the need to improve corporate governance in the banking sector as a key priority, and subsequently established a Task Force of Eurasian and international experts to develop this report. As one of the more advanced sectors in Eurasia, banks' corporate governance practices can play an important role in underpinning economic stability and growth in the region. Good corporate governance of banks is essential to maintaining their sound and proper functioning. In addition, good corporate governance can help to increase confidence in the financial system as a whole, an important consideration following the significant number of bank failures that have already occurred in Eurasia during the transition period. Moreover, Eurasian banks often occupy a position in which they can, if they wish, influence the corporate governance of their corporate borrowers. It is hoped that this *Policy Brief* can help Eurasian banks not only to improve their own governance, but also to become role models for other companies in the region to follow their lead.

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Policy Brief on Corporate Governance of Banks in Eurasia

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Executive Summary

Good corporate governance practices of banks are essential to maintaining the sound and proper functioning of the banking sector. It is often argued that bank failure might involve systemic risks and have a huge negative impact on depositors, other stakeholders and the economy as a whole. Bank failure might also undermine one of the core elements of the market economy, that is, people's confidence in banks – a painful experience that has already occurred in the transition period in Eurasia. The interests of depositors deserve special attention in a discussion of bank corporate governance.

There are additional reasons why bank governance should be enhanced in the Eurasian context. The banking sector is one of the most advanced and well organised in many Eurasian countries. Furthermore, Eurasian banks often occupy a position in which they can, if they wish, influence the corporate governance of their corporate borrowers. Banks in Eurasia are expected, if not required, to become role models for other companies in implementing better corporate governance.

Aiming at improving bank corporate governance in Eurasia, and based on well-known international standards such as the *OECD Principles of Corporate Governance* and the Basel Committee's guidance *Enhancing Corporate Governance for Banking Organisations* ("Basel CG Guidance"), the discussion for this policy brief by the Task Force was developed in the Eurasian context. This policy brief is a non-binding document and does not aim at detailed prescriptions for national legislation. Rather, it seeks to identify objectives and suggest various means for achieving them. Its purpose is to serve as a reference point together with other international guidance mentioned above.

Boards, board members and specialised committees

In relation to Principle 1 of the Basel CG Guidance, "*Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.*":

Together with guiding corporate strategy, the boards (or supervisory boards) are chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands of relevant stakeholders. In terms of banks, bank boards should also be aware of their responsibilities to depositors including the general public who entrust their everyday savings.

In order for bank boards (or supervisory boards) to exercise objective and independent judgment, banks in Eurasia should be required to have a sufficient number of independent directors. For the purpose of helping independent directors actively influence the boards' decisions, a recommended policy option is to allocate to them specific roles such as chairperson of the board (or lead non-executive director, if the chair is also the CEO). The "independent directors" are not just non-executive directors. They cannot be affiliated with senior management in terms of former employment, any material business relationship, additional remuneration, close family ties or cross directorships. Moreover, they need to be independent of controlling shareholders. The Annex attached proposes a set of criteria defining when an individual is not regarded as an independent director (negative criteria). In addition to the negative criteria, banks should take some positive attributes into consideration to complement the negative criteria when recruiting independent directors.

The boards (or supervisory boards) should have adequate collective knowledge of the major financial activities the banks pursue. Banking supervisors and/or banking industry associations should help banks implement board training programs or even provide training programs themselves. Such programs should include subjects that would provide full understanding and awareness of the board's responsibilities in terms of corporate governance.

The Basel CG Guidance recommends that banks should have an audit committee. The Task Force believes that all audit committee members should be financially literate and at least one member should possess recent and relevant specialist knowledge in financial reporting, accounting or auditing. The audit committee should be composed in a way that independent directors can exert influence in order to help ensure objective judgments.

The Basel CG Guidance also notes that nomination committees and remuneration committees have become increasingly common in a number of countries. In addition, establishing a specialised committee focusing on risk management (e.g. risk management committee) is recommended. Senior management would regularly report to this committee for its review on the overall risk profile and the quality of loan/asset portfolio. Senior management would also request approval from the committee about the bank's risk policy that would include specifying the types and degree of risk that the bank is willing to accept in pursuit of its goals. However, what matters most is that a bank should have well-functioning committees; it matters less how many committees a bank has. If the size of the bank is small or the number of board members including independent directors is limited, the responsibilities of some board committees can be combined in order to ensure effective, lively discussions and independent judgment of the committee.

Bank's strategic objectives, corporate values and high standards of professional conduct

In relation to Principle 2 of the Basel CG Guidance, "*The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.*":

Bank boards (or supervisory boards) should be responsible for reviewing and guiding the development of bank strategies, major action plans, and company "mission statements" into documents. Banks are also encouraged to develop company codes of conduct based on professional standards. In so doing, however, the supervisory boards should be able to receive the necessary support and suggestions from the management boards including the development of preliminary drafts when appropriate.

The boards (or supervisory boards) should be responsible for ensuring that a compliance-oriented culture prevails throughout the banks. They should ensure that, through senior management, awareness-raising programs on compliance functions are provided for bank employees and that bank employees are promoted and remunerated or reprimanded in accordance with their conformity with the bank's objectives, policies and values as one of the key elements of personnel evaluation. The bank should report regularly, in its publicly disclosed annual report, for instance, on its compliance structure and activities, and on its implementation actions. Bank boards (or supervisory boards) should establish procedures (including a contact point and a confidential direct access) for reporting of unethical/unlawful behaviour and assure employees of their protection who wish to communicate concerns.

Related party transactions entail specific risks. These transactions should be made on an arm's length basis and materially important ones should be subject to prior approval by the boards (or supervisory boards), disclosed and reported to banking supervisors. On approving (or rejecting) materially important related party transactions, the boards (or supervisory boards) should require clear proof that these transactions are on market terms and conditions. A committee of the board (or supervisory board), whether it is called audit committee, risk management committee, credit committee or other, can be useful for this purpose as far as it comprises independent directors and those who have expertise in bank finance. Another option can be an outright banning of certain types of related party transactions. This may include a ban on personal lending to the board members, senior management, controlling shareholders, and their close relatives, possibly with exceptions for some standardised lending such as housing loans to employees on market terms.

Clear lines of responsibilities and accountability

In relation to Principle 3 of the Basel CG Guidance, "*The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.*":

Unspecified lines of accountability or confusing, multiple lines of responsibility may create a vacuum in which nobody is fully in charge. In order to avoid such a risk, the boards (or supervisory boards) should hold supervisory powers over senior management (including management boards). However, in some Eurasian countries with a two-tier board structure, the members of management boards are appointed at general shareholder meetings, not by supervisory boards. Even if laws provide shareholders with the power of appointments/removals, supervisory boards should propose such appointments/removals at the general shareholders meetings. On the other hand, senior management (or the management board) is responsible for delegating duties to the staff and establishing a management structure that promotes accountability. Senior management (or the management board) has the obligation to oversee the exercise of such delegated responsibility, and the board (or supervisory board) should ensure this.

Oversight by senior management and internal control functions

In relation to Principle 4 of the Basel CG Guidance, "*The board should ensure that there is appropriate oversight by senior management consistent with board policy.*":

Internal control is a process, effected by the board, senior management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives (e.g. performance objectives, information objectives and compliance objectives). In varying degrees, internal control is the responsibility of everyone in banks. It has become more extensive, addressing all the various risks faced by corporations. Banks should continuously monitor and evaluate the effectiveness of their own internal controls in addition to evaluations made by internal auditors (and often by external auditors). Senior management should establish and improve banks' internal control systems based on these evaluations. The boards (or supervisory boards) should guide senior management and ensure that they properly establish, implement, monitor and evaluate the effectiveness of, and constantly improve, the internal controls.

One of the key issues that internal controls should address is checks and balances, or the "four eyes principle" (i.e. segregation of duties, cross-checking, dual control of assets and double signatures). The boards and senior management should nurture a bank culture in which control activities such as the implementation of the *four eyes principle* are regarded as an integral part of daily operations.

Internal audit and external auditors

In relation to Principle 5 of the Basel CG Guidance, "*The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.*":

Internal audit is part of the ongoing monitoring of the bank's system of internal controls. There are different types of internal audits including, but not limited to, financial audits, compliance audits and operational audits. The internal audit function ought to have appropriate status within the bank to ensure that senior management reacts to and acts upon its recommendations. It should have a direct reporting line to the board (or supervisory board) or the board audit committee. Internal auditors should be suitably trained and have relevant experience to understand and evaluate the business they are auditing.

The internal audit function in some Eurasian countries often involves the participation of *Revision Commissions* that are either given direct responsibility for the internal audit function or instruct the internal audit units/divisions/departments. They are separate bodies from the boards or senior management. Their members are appointed at the general shareholders meetings. However, if the *Revision Commissions* do not seem to be functioning effectively, the option of removing them from any legislation, or, at least, repealing the mandatory requirement to establish them is strongly recommended. Moreover, the Task Force believes that *Revision Commissions* cannot substitute for the board audit committee, the establishment of which is now internationally recommended. Reflecting the global trend in which the role and responsibility of the boards are increasingly highlighted and enhanced, abolishing *Revision Commissions* by shifting their functions to the board audit committees should be considered as one of the policy options.

Qualified and independent external auditors are expected to play an important role in helping ensure sound corporate governance. In addition, in many respects, the banking supervisor and the bank's external auditor have complementary concerns regarding the same matters, though the focus of their concerns is different. Banking laws should provide the legal basis on which banking supervisors are entitled to receive information from external auditors. While taking into account the necessity to safeguard the normal relationship between banks and their external auditors, such external auditors should be required to report to the banking supervisors when they detect crimes or other significant breaches of laws. Laws should provide statutory immunity in which external auditors cannot be held liable for information disclosed to banking supervisors. Furthermore, it is recommended that the banking supervisors have the statutory power to reject and rescind the appointment of a bank's external auditor if the auditor is deemed to have inadequate expertise or independence, or does not follow established professional standards.

Compensation

In relation to Principle 6 of the Basel CG Guidance, "*The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.*":

An extraordinarily low level of remuneration of board members is no more desirable than an extraordinarily high level. This should be particularly underlined for bank boards in countries where there is a tradition in which serving as board members is often an honorary job or a kind of social contribution. Banks need boards that can effectively perform their jobs backed by professionalism and members of boards should be sufficiently remunerated in accordance with the responsibilities they are expected to fulfill. Zero or extraordinarily low remuneration of a bank board (or supervisory board) would rather indicate that the board may not be functioning very well. For countries where there are neither prevailing market rates nor accumulated business practices in terms of remuneration, banking supervisors (or banking industry associations, etc.) may need to develop guidance on this. The guidance should ask individual banks' remuneration policy to specify how it aligns remuneration with the long term interest of the bank.

Transparency and disclosure of information in terms of corporate governance

In relation to Principle 7 of the Basel CG Guidance, "*The bank should be governed in a transparent manner.*":

The third pillar of Basel II focuses on regulations that require accurate information disclosure and facilitate market oversight and discipline of banks. National laws/regulations/rules should require banks, whether listed or not, to comply with high quality accounting and disclosure standards consistent with internationally accepted standards. In addition, banks should have their financial statements audited by an external auditor in accordance with high quality internationally accepted auditing practices and standards.

One of the most important information disclosures for some Eurasian banks would be regarding ownership structure (e.g. major share ownership and voting rights, beneficial owners, major shareholder participation on the board or in senior management positions). An opaque ownership structure poses a significant risk on the depositors, other stakeholders and minority shareholders. Information about record ownership has to be complemented with information about beneficial ownership (ultimate owner). Where such information is not known to the bank, the regulatory system should ensure that such information can be obtainable at least by regulatory and enforcement agencies and/or through the judicial process.

Concerning compliance with disclosure requirements by listed banks, the Task Force would like to stress the importance of co-operation between banking supervisors and capital market authorities. For instance, problems regarding disclosure by an individual listed bank identified either by banking supervisors or capital market authorities should be shared by both organisations in due course for possible corrective actions and sanctions/penalties according to relevant laws/regulations.

Corporate governance of state-owned/controlled commercial banks (SOCBs)

SOCBs face some governance challenges that are either unique or are more acute than those faced by private sector banks. For instance, SOCBs are often protected, whether explicitly or not, from bankruptcy, competition and takeover – the threats that would otherwise have disciplined management behaviour. The Task Force's discussion on this subject was based on the *OECD Guidelines on Corporate Governance of State-Owned Enterprises.*

The state should not be a passive, indifferent owner that simply acts as a rubber stamp. It should develop and make public an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOCBs, and how it will implement its ownership policy. The objectives stipulated in the ownership policy may include the pursuit of profitability in the form of specific targets (e.g. the rate of return or dividend policy) but may also include trade-offs, for instance, between shareholder value and public service. The state should therefore indicate its priorities in its ownership objectives.

At the same time, the state should refrain from unduly intervening in SOCBs' management. Instead, the state should respect and take advantage of SOCB's corporate form (i.e. legal governing structure). The boards of SOCBs should act professionally and include a sufficient number of "independent" members so that they are able to make decisions independent of the state's possible (politically driven) day-to-day intervention, while effectively monitoring the management in accordance with the objectives set by the state.

SOCBs, whether listed or not, should be subject to an annual, independent external audit in addition to the specific state audit which is often designed principally to monitor public funds and the use of budget resources. The state should maintain a continuing dialogue with the external auditors of SOCBs so long as this is compatible with relevant laws.

Banks' monitoring of the corporate governance practices of their corporate borrowers

The question here is what roles are Eurasian banks expected to play (or not to play) in relation to the corporate governance of their corporate borrowers? Banks should recognise that it is in the best interests of the banks themselves to assess and monitor, *ex-ante* and *ex-post*, the corporate governance structures and practices of their corporate borrowers to the extent that those structures or practices affect the borrowers' creditworthiness. Banking supervisors in Eurasia should therefore encourage banks to assess and monitor the quality of the corporate governance of their debtor companies as a critical part of their ongoing credit risk management.

On the other hand, banks' interests do not necessarily converge with those of other stakeholders. To avoid conflicts of interest and to contribute effectively to the enhancement of borrowers' corporate governance, banks should play a transparent role and thus the governance-related requirements they may impose on their borrowers should be clearly stated in advance (i.e. included in covenants) where appropriate. For instance, such a covenant could, depending on the size of the corporate borrowers, stipulate conditions regarding the corporate governance structure of the borrowers (e.g. inclusion of independent directors). The covenant should include the obligation for corporate borrowers to report deviation to the bank, which would in turn reduce the burden of monitoring by the bank.

The role of supervisors and the next steps

In relation to section IV of the Basel CG Guidance: "*The role of supervisors*":

Although the Task Force believes more effective banking supervision is increasingly needed in the region, banking supervision, especially direct regulation by which banking supervisors try to prevent and correct the wrongdoings of banks, is by no means a panacea. Banking supervisors should therefore put more emphasis on promoting good corporate governance of banks in which banks, under the guidance and oversight of their boards (or supervisory boards), would naturally implement sound banking practice. Banking supervisors should determine whether the bank has adopted and indeed effectively implemented sound corporate governance policies. They should also assess the quality of banks' internal control functions, internal audit and external audit.

While 'hard law" (i.e. laws and regulations) is essential for ordinary banking supervision, corporate governance objectives are often formulated in the form of 'soft law' – namely, voluntary corporate governance codes that do not have the status of law/regulation or direct binding force. It is recommended that Eurasian countries also seek an appropriate combination of hard law and soft law. These codes are often implemented on what is called a "comply or explain" basis in which firms that do not comply with the requirements have to clearly explain the reasons for non-compliance to their shareholders. The "comply or explain" approach is strongly recommended as international best practice. The Basel CG Guidance makes it clear that banking supervisors should provide guidance to banks on sound corporate governance and pro-active practices that should be in place. The Task Force recommends that banking supervisors (or banking industry associations, while exchanging views with banking supervisors) in Eurasia, in conjunction with securities regulators and stock exchanges, should develop and publicise a code of corporate governance for banks, in the form of a template on which individual banks should base the development of their own codes (i.e. individual banks' corporate governance codes).

Background and Objectives

1. The Eurasian Corporate Governance Roundtable ("Roundtable")[1] organised by the OECD (Organisation for Economic Co-operation and Development) serves as a regional forum for structured policy dialogue on corporate governance. Participants in the Roundtable from the Eurasian region have included those from Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Mongolia, Ukraine and Uzbekistan. In 2004, the Roundtable agreed *Corporate Governance in Eurasia: A Comparative Overview* ("Roundtable Comparative Report")[2], which provided region-specific priorities and recommendations for reform aimed at improving corporate governance to assist policy makers, regulators, stock exchanges, and other standard-setting bodies in Eurasian countries.

2. The Roundtable Comparative Report identified corporate governance of banks as one of the priorities for reform and recommended that "governments should intensify their efforts to improve the regulation and corporate governance of banks" (Roundtable Comparative Report, pp. 12-13). Responding to this recommendation, at its 2006 meeting in Istanbul, the Roundtable decided to establish a task force to develop a policy options paper ("policy brief") addressing corporate governance challenges shared by commercial banks in Eurasia. It was intended that the policy brief would focus on policy issues and options and in turn would support efforts in Roundtable countries to improve corporate governance of banks in their jurisdictions.

3. This policy brief has been developed through active discussion[3] within the Task Force on Corporate Governance of Banks in Eurasia ("Task Force"). The Task Force included experts from the nine Eurasian countries mentioned above together with an expert from Tajikistan. It also included experts from some OECD member countries and international organisations. The OECD, with the support of the EBRD (European Bank for Reconstruction and Development), served as the secretariat for the

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[1] http://www.oecd.org/document/38/0,2340,en_2649_37439_2048422_1_1_1_37439,00.html

[2] http://www.oecd.org/dataoecd/18/63/33970662.pdf

[3] The Task Force is basically an electronic discussion group but had an actual meeting for discussion in Tbilisi, Georgia in May 2007.

Task Force. It should be noted that the Task Force comprised both experts in banking and capital markets who had each been discussing this priority topic from their own perspectives. While all members of the Task Force occupy senior positions in their respective organisations, the findings and opinions expressed in this policy brief are personal and do not necessarily reflect the views of the organisations they serve or their countries of origin.

4. This policy brief is a non-binding document and has been prepared on a consensus basis. It does not aim at detailed prescriptions for national legislation or regulation, but seeks to identify objectives and to suggest various means for achieving them. It does not address, with some exceptions, many corporate governance-related issues in banks that overlap with issues that are also relevant to non-financial companies (i.e. more generic corporate governance-related issues). Some recommendations in this policy brief may call for a fine tuning of implementation especially when applied to small banks. The purpose of the policy brief is to serve as a source of reference together with the *OECD Principles of Corporate Governance* ("OECD Principles")[4], the *Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance*[5], the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* and the Roundtable Comparative Report.

5. The Basel Committee on Banking Supervision ("Basel Committee") has revised its guidance *Enhancing Corporate Governance for Banking Organisations* ("Basel CG Guidance")[6]. The Basel Committee's other guidance, such as the *Core Principles for Effective Banking Supervision,* the *Internal Audit in Banks and the Supervisor's Relationship with Auditors* and a number of other risk management and sound practice papers also provide recommendations that enhance corporate governance of banks. The Task Force does not intend to develop any new international standard, but is more concerned with effective implementation of existing norms. The discussion of the Task Force has drawn on them for guidance. The first seven chapters of the

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[4] http://www.oecd.org/document/49/0,2340,en_2649_37439_31530865_1_1_1_37439,00.html

[5] The *Methodology* has been recently developed by the OECD in order to underpin an assessment of the implementation of the OECD Principles in a jurisdiction.
http://www.oecd.org/dataoecd/58/12/37776417.pdf

[6] http://www.bis.org/press/p050729a.htm

recommendation section of the policy brief, while reflecting the Eurasian context, actually correspond to the first seven principles of the Basel CG Guidance.

6. A number of bodies are involved in ensuring sound corporate governance of banks. The primary responsibility for developing and implementing sound corporate governance of banks rests with the individual bank itself. Non-profit organisations such as banking industry associations and institutes of directors often play an important role in assisting the boards and senior management of banks to fulfill their responsibilities. Capital market authorities including stock exchanges have their own jurisdiction over listed banks. Banking supervisors are responsible for providing a regulatory framework and guidance and they should also monitor individual banks, taking necessary measures when a bank fails to achieve the minimum corporate governance standards. This policy brief is therefore addressed to a wide range of participants, including banks, banking industry associations, institutes of directors, capital market authorities, banking supervisors and policy makers. The policy brief together with the other documents mentioned above can be used by banks as they try to develop and implement sound corporate governance practices that will in turn result in safer and sounder functioning of the banks. Policy makers, supervisors and others may find these documents of use as they examine and develop the legal, regulatory or voluntary frameworks for banks in the Eurasian region.

Introduction

7. The OECD Principles[7] define corporate governance as involving "*a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.*" Companies are increasingly aware of the importance of good corporate governance and policymakers around the world now regard improving corporate governance standards as a priority in order to ensure a high level of sustainable economic performance in their countries.

8. Good and effective corporate governance practices of banks are essential to maintaining the sound and proper functioning of the banking sector. The reasons why bank corporate governance is important would, therefore, mostly overlap with the reasons why sound and proper banking must be ensured. There has been much discussion around the world about the necessity of sound and proper banking; it would usually include those arguments which focus on the critical functions that should be properly performed by banks in deposit taking, credit allocation and payment systems. It is often argued that bank failure might involve systemic risks and have a huge negative impact on depositors, other stakeholders and the economy as a whole[8]. Bank failure might also undermine one of the core elements of the market economy, that is, people's confidence in banks – a painful experience that has already occurred early on in the transition period in Eurasia. The Task Force agrees with these arguments that are now commonly shared by many banking supervisors. The policy brief, therefore, does not go into details about such arguments while pointing out one factor that differentiates the discussion of bank governance from that of general

[7] Preamble

[8] It does not necessarily mean individual banks must be protected.

corporate governance: the interests of depositors. The interests of depositors[9] deserve special attention in a discussion of bank corporate governance, in addition to the interests of minority shareholders as in the discussion of corporate governance of non-banks.

9. Apart from the arguments above, there are additional reasons why bank corporate governance should be enhanced in the Eurasian context. The banking sector is one of the most advanced and well organised in many Eurasian countries. Furthermore, banks often occupy a position in which they can, if they wish, influence the corporate governance of their corporate borrowers. From the viewpoint of ensuring sustainable economic development in transition economies, banks in Eurasia are expected, if not required, to become role models for other companies in implementing better corporate governance.

10. In order to improve bank corporate governance in Eurasia, the following chapters propose various policy options that can be implemented in the region. Based on well-known international standards such as those of the OECD and the Basel Committee, the discussion of the Task Force has been developed in the Eurasian context. Some general aspects of the policy brief especially in relation to the Eurasian context should be noted at the outset.

11. First, many Eurasian countries are referred to as having two-tier board structures. In practice, the operation of two-tier board structures and the internationally widespread unitary board structures often converge because of the intensive interaction of the supervisory boards (the upper boards) and the management boards (the lower boards) in two-tier board structures. The role of the management boards in Eurasian countries is often limited to day-to-day management. Unlike typical two-tier boards in Germany or Austria, the management boards in Eurasia are not legally expected to jointly establish, together with the supervisory boards, corporate objectives, strategies or fundamental policies. In that sense, most Eurasian two-tier board system may in practice be closer to a unitary board system that has, in addition to the board, an

[9] The Basel CG Guidance states that supervisors should consider corporate governance as one element of depositor protection (Section IV).

executive group (though not as a statutory body) that meets regularly. Against this background, similar to the OECD Principles and Basel CG Guidance, the terms "board" and "senior management" as used in this document are not to identify specific legal bodies of banks, neither two-tier boards nor unitary boards, but rather to label supervisory functions and management functions, respectively. Supplementary explanations for clarification specifically regarding the two-tier board structures are made where appropriate.

12. Second, in many Eurasian countries, whether they adopt two-tier board or unitary board structures, banks or joint stock companies in general are legally required to have another statutory body responsible for (or, at least, in relation to) internal audit or supervisory functions[10]. Organisational structures, functions or responsibilities of these statutory bodies are not necessarily identical across Eurasian countries. For instance, in many countries they are collegial bodies but in others they can include one-person bodies as an option, and their functions and responsibilities can either be limited to the financial audit purpose or rather broader ones including compliance functions. However, the members of these bodies are legally required to be directly elected/appointed at the general shareholders meetings and the members of such bodies are legally prohibited from concurrently serving as members of the boards or executive bodies. Laws provide them with separate powers and responsibilities from those of the boards and thus they are not under the auspices of the boards. They are not just an internal unit/department for internal audit because they do not report to the boards or senior management. Such a governing structure is one of the major, defining characteristics of companies in Eurasia, even if it is not unique to the region[11]. This structure is sometimes confusing to foreigners because these statutory bodies are often translated into English as "Supervisory Boards" or "Audit Committees", but they are neither the boards nor board committees. This policy brief calls them "*Revision Commissions*" and discusses their responsibilities where appropriate. The *Revision Commissions* as defined above can be seen in Armenia, Azerbaijan, Georgia, Moldova, Mongolia, Ukraine and Uzbekistan.

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[10] They are different from general shareholders meetings or external auditors.

[11] For instance, similar examples can be seen in Russia, Italy, Portugal and some jurisdictions in East Asia.

Recommendations

Chapter 1: Boards, board members and specialised committees

This chapter relates to Principle 1 of the Basel CG Guidance and its annotations: "*Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.*"

13. **The boards (or the supervisory boards in two-tier board systems) increasingly are expected to serve as a key fulcrum in corporate governance between shareholders and professional management.** Together with guiding corporate strategy, the boards (or supervisory boards) are chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands of relevant stakeholders. The board members owe fiduciary duties (i.e., the duty of care and the duty of loyalty) to the company and all its shareholders. **In terms of banks, the bank boards should also be aware of their responsibilities to depositors including the general public who entrust their everyday savings.**

Independent Directors

14. In order for bank boards (or supervisory boards) to exercise objective and independent judgment, it would naturally be required that a sufficient number of board (or supervisory board) members be independent of senior management. Although in two-tier board systems the supervisory board is by law non-executive, the "independent directors" are not just non-executive directors. The best practice seen in OECD member countries now seems to require that **independent directors cannot be affiliated with senior management in terms of former employment, any material business relationship, additional remuneration from the company, close family ties or cross directorships.** Moreover, the national corporate governance codes in more than one third of OECD member countries, including those that adopt two-tier board systems, are now also concerned with the need for **independent**

directors to be independent of controlling shareholders[12]. The importance of such a requirement will depend on national conditions (e.g. whether listed companies with controlling shareholders are common). There seems to be a strong need in most Eurasian countries for such directors since, as the OECD Principles[13] explain, the independence from controlling shareholders will need to be emphasised, in particular where the *ex-ante* rights of minority shareholders are weak and opportunities to obtain redress are limited.

15. **The Annex attached proposes a set of criteria defining when an individual is not regarded as an independent director.** Such "negative criteria" can also be usefully complemented by "positive attributes", examples of qualities that will increase the probability of effective independence. Some of these qualities desirable for the independent directors are[14]: (i) having an adequate professional background, (ii) showing integrity and the highest ethical standards and (iii) possessing sound judgment, an inquiring mind and healthy skepticism. In addition, a couple of additional attributes may supplement these qualities. For instance, having strong interpersonal skill may help the independent directors discuss controversial issues without causing serious friction within the board. If the independent director has already built up an excellent reputation and does not want to lose it, he/she may try to monitor senior management with closer attention than otherwise for fear that a bank failure would damage his/her reputation. **In addition to the negative criteria, banks should take the positive attributes into consideration when recruiting independent directors**.

16. Regulations in relation to independent directors should take into account national conditions, namely, the fact that there may not be a large enough pool of experienced

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[12] For more information on independent directors, see OECD, *Survey of Corporate Governance Developments in OECD Countries,* pp. 61-66. (http://www.oecd.org/LongAbstract/0,3425,en_2649_34813_21755679_119699_1_1_1,00.html)

[13] Annotations to Principle VI E.

[14] In consultation with the OECD, a task force of IOSCO (International Organization of Securities Commissions) developed a report on board member independence of listed companies (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD238.pdf). The report also includes discussion about the positive attributes (pp 32-33).

candidates to serve as independent directors in many Eurasian countries. It is true that, for instance, requiring a higher proportion of independent directors in the board might normally enhance the objectivity of board decisions, but it would not be practical to force it on banks if it is an overly ambitious target[15]. It would therefore be inappropriate to suggest a "one-size-fits-all" quantitative answer for Eurasian countries on this issue[16] but suffice to say that Eurasian banks should be required to have a "sufficient" number of independent directors. Instead, in order to help independent directors actively influence the board's decisions even if they do not outnumber other members, **a recommended policy option is to allocate to them specific roles such as the chairperson of the board (or lead non-executive director, if the chair is also the chief executive officer).** The chairperson should not only be responsible for leadership of the board and setting its agenda but also ensuring that directors receive sufficient information in a timely manner and facilitating the effective contribution of independent directors[17]. **For countries with two-tier board systems, therefore, it is also important to prohibit a former member of a management board from chairing a supervisory board**[18].

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[15] From the same point of views, it may be premature for some countries without a sufficient pool of suitable candidates to impose limitations on the number of board positions one director can hold concurrently. Such specific limitations may be less important than ensuring that members of the board enjoy legitimacy and confidence in the eyes of shareholders, depositors and the regulators. Achieving legitimacy would also be facilitated by publishing the attendance records for individual board members and any other work undertaken on behalf of the board and the associated remuneration. (See Annotations to Principle VI E 3 of the OECD Principles)

[16] The practices in OECD member countries also vary from the Netherlands where all supervisory board members except one person should be independent directors, to Germany where there is no quantitative standard in terms of a minimum number/proportion of the independent directors.

[17] The company secretary (corporate secretary) as a senior administrative officer of the bank can contribute to ensure that the board members (independent directors, especially) obtain accurate, relevant and timely information. The responsibilities of the company secretary should not only be the clerical one (e.g. preparing minutes of board meeting or maintaining the bank's company record) but also include a wide range of duties. For instance, the board should have access to the company secretary's advice on legal, regulatory and procedural matters as well as governance related issues.

[18] It is consistent with what is now regarded as good practices seen in OECD member countries that use dual board systems.

Board Member's Qualification

17. **The boards (or supervisory boards) should have adequate collective knowledge of the major financial activities the banks pursue[19]. They also should have the collective knowledge and expertise necessary for effective governance and oversight.** It does not mean that every member of the board (or supervisory board) ought to have detailed knowledge before appointment[20] but some members should have a sufficient knowledge of banking (not just general business experience in the non-financial sector). In any case, banks are encouraged to implement programs of ongoing education for the members of the board (or supervisory board). Banking supervisors and/or banking industry associations, in cooperation with international organisations where available and appropriate, should help banks implement such programs or even provide training programs themselves. It is recommended that **the programs should include subjects that would provide full understanding and awareness of the board's responsibilities in terms of corporate governance.**

Board Committees

18. In many OECD member countries, bank boards have found it beneficial to establish certain specialized committees. These committees are usually established within/under the boards (or supervisory boards) so that they can enhance the function of the boards by mobilizing boards' experts into intensive, small-group discussion as well as by assuring, when independent directors play key roles in the committees, impartial judgment.

19. The Basel CG Guidance recommends that **banks should have an audit committee** or equivalent structure responsible for similar functions. Typically, it is responsible for providing oversight of the bank's internal and external auditors; approving[21] the

[19] Because of their duties, bank boards are often larger than the boards in other companies.

[20] Needless to say, a member of senior management (or the management boards) in charge of banks' day-to-day operations ought to have the necessary knowledge in banking before appointment.

[21] Or recommending to the board (or shareholders) for an approval in the jurisdictions where laws provide the legal authority to the entire board (or general shareholders meetings) to approve such matters.

appointment, compensation and dismissal (i.e. cancelation or termination of contract) of external auditors; reviewing and approving audit scope and frequency; receiving audit reports; and ensuring that management is taking appropriate corrective actions to address control weakness and non-compliance. In Eurasian countries where laws require the establishment of *Revision Commissions* whose responsibilities overlap with some of the above, an option for policy makers would include abolishing them and integrating their powers with the new board audit committees (See chapter 5 for more discussion). **All audit committee members should be financially literate and at least one member should possess recent and relevant specialist knowledge in financial reporting, accounting or auditing[22].** The audit committee should be composed in a way that independent directors can exert influence in order to help ensure objective judgments.

20. The Basel CG Guidance notes that **nomination committees (or corporate governance committees or human resources committees) and remuneration committees have become increasingly common in a number of countries.** The nomination/corporate governance/human resources committee, not prevalent in Eurasia, can provide an assessment of board (or supervisory board) effectiveness and direct the process of renewing and replacing board (or supervisory board) members. It might prepare recommendations by the board (or supervisory board) to general shareholder meetings for the election of board members. (Further discussion on nomination process will be made in Chapter 3.)

21. **Specialised committees focusing on risk management are seen in many, if not all, Eurasian banks.** These are called, for instance, credit committees, risk management committees or asset and liability management (ALM) committees[23]. This illustrates that managing various risks in banking is just as important in Eurasia as in other parts of the world. These committees should provide effective oversight of senior management's activities in managing risks. For this purpose, senior management

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[22] Such experts in financial reporting, accounting and auditing should not be held more liable than other audit committee members because of their expertise.

[23] Some of the committees above may cover all major categories of risks known in banking business while others may place particular focus on some specific types of risks (e.g. credit committees for credit risk, ALM committees for liquidity and interest rate risk).

should regularly report to the committee for its review on the overall risk profile and the quality of loan/asset portfolio. Senior management should also request approval from the committee about the bank's risk policy that would include specifying the types and degree of risk that the bank is willing to accept in pursuit of its goals. In order to empower the board (or supervisory board), which should play key roles in corporate governance, these committees would usually be established as board (or supervisory board) committees[24].

22. One of the pitfalls that banks should avoid would be merely establishing the formality of committees. All of the committees mentioned above should be able to make objective independent judgment through intensive discussion backed by professionalism and appropriate expertise. **What matters most is that a bank should have well-functioning committees. It matters less, for instance, how many committees a bank has.** If the size of the bank is small or the number of board members including independent directors is limited, the responsibilities of some board committees can be combined in order to ensure effective, lively discussions and independent judgment of the bank's committee.

[24] In many banks in OECD member countries that adopt two-tier board systems, these committees are the committees of supervisory boards. However, it is not the case in several Eurasian countries, and it is claimed that such a system (i.e. some of these committees are established as management board committees) actually functions there. The Task Force therefore has not reached a conclusion as to whether or not they should be supervisory board committees. This may be because some of these committees seen in Eurasia are expected to serve more as a management tool than a monitoring tool. It is understandable that senior management tries to manage risks as a group by using the form of a committee (i.e. management board committee). In such a case, though, the supervisory board still has a duty to monitor the risk management undertaken by the management board and to oversee risk policy.

Chapter 2: Bank's strategic objectives, corporate values and high standards of professional conduct that address conflicts of interest and unethical behaviour

This chapter relates to Principle 2 of the Basel CG Guidance and its annotations: "*The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.*"

Strategic Objectives, Major Action Plans and Other Guiding Policy Documents of Banks

23. Banks in Eurasia, at least large ones, usually develop bank strategy, major action plans and company "mission statements" into documents. **Bank boards (or supervisory boards) should be responsible for reviewing and guiding the development of these strategies, plans, etc**. and most laws in the region actually stipulate this[25]. The risk policy as discussed in paragraph 21 should also be documented. Banks are also encouraged to develop company codes of conduct based on professional standards. In so doing, however, active involvement and contribution by senior management (or the management boards) is indispensable for making them really practical and enforceable. There is a potential risk of building castles in the sky especially for two-tier boards that separate supervisory function and management function into different bodies. Some corporate governance codes in OECD member countries with two-tier board systems (e.g., Germany, Austria and the Netherlands) therefore clearly require the management boards to contribute to the supervisory boards that approve the strategies, etc. **The supervisory boards should be able to receive the necessary support and suggestions from the management boards including the development of preliminary drafts when appropriate.** Regulations or national corporate governance codes should clarify this for banks.

[25] A banking law in one of the Eurasian countries separates the responsibility for developing certain types of bank policies between the supervisory board and the management board in accordance with the nature of the policies.

Compliance Oriented Bank Culture

24. Beyond documentation of strategies and policies, the greater challenge lies in nurturing a bank culture in which senior management and bank employees really understand the bank's strategies and seek to comply with its polices and values, including those regarding ethics and compliance rules. There is no magic formula for this but, in any event, **the boards (or supervisory boards) should be responsible for ensuring that such a compliance-oriented culture prevails throughout the banks.** The boards (or supervisory boards) should ensure that, through senior management, awareness-raising programs on compliance functions are provided for bank employees and that bank employees are promoted (and remunerated) or reprimanded in accordance with their conformity with the bank's objectives, policies and values as one of the key elements of personnel evaluation. The boards should analyse major incidents in which bank employees failed to meet the bank's objectives, policies and values in order to identify how to make the objectives, policies and values actually prevail throughout the bank. The members of the boards (or supervisory boards) should be role models for management and employees in implementing the objectives, policies and values. They should ensure that a code of ethical behaviour (or a code of conduct) covering compliance with the law and professional standards is developed and is also applied to board members themselves. **The bank should report regularly, in its publicly disclosed annual report, for instance, on its compliance structure and activities, and on its implementation actions[26].**

25. In order to ensure that corporate values, especially those related to compliance functions and ethics, effectively prevail throughout banks, it is important for the boards (or supervisory boards) to encourage the reporting of unethical/unlawful behaviour without fear of retribution. **The bank boards (or supervisory boards) should establish procedures for such reporting, including a contact point and a confidential direct access[27], and assure employees who wish to communicate**

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[26] The implementation actions here include the remedies taken in response to the reporting of unethical/unlawful behaviour (see paragraph 25).

[27] The contact point should be independent from management. It can be a member of the audit committee (or ethics committee) or a person (inside or outside of the bank) designated by the boards (or supervisory boards),

concerns of their protection. These procedures should clearly stipulate the obligation of the boards (or supervisory boards) to address (or to make senior management address under their supervision) *bona fide* reporting. Banking supervisors should take whatever measures possible within their jurisdiction to be reasonably confident that bank boards (or supervisory boards) actually encourage bank employees to communicate their legitimate concerns without fear of retaliation.

Related Party Transactions

26. The Basel Committee's *Core Principles for Effective Banking Supervision*[28] together with its *Core Principles Methodology*[29] state in Principle 11 how related party transactions should be regulated. For instance, **these transactions should be made on an arm's length basis and materially important ones should be subject to prior approval by the boards (or supervisory boards), disclosed and reported to banking supervisors**. The second Principle of the Basel CG Guidance also devotes a large portion of its annotations to controlling conflicts of interest including related party transactions. Preventing abusive related party transactions in banks is an important policy goal for ensuring sound banking. Banking supervisors in Eurasia seem to think such transactions, especially those between banks and shareholders, or banks and company groups, need particular attention. Eurasian countries have, in most cases, developed various regulations in relation to this. However, ensuring the appropriate implementation and enforcement of such regulations can be the most challenging part.

27. Related party transactions entail specific risks and it is particularly important that they are made on market terms and conditions. However, it is not always clear in practice if a transaction is made on an arm's length basis especially when there are many factors to be considered including the estimation of the risk of borrowers, which requires technical skills and may be easily, intentionally, underestimated. On approving (or rejecting) materially important related party transactions, **the boards (or supervisory boards) should require clear proof that these transactions are on**

[28] http://www.bis.org/publ/bcbs129.pdf

[29] http://www.bis.org/publ/bcbs130.pdf

market terms and conditions and are not unfair to the bank, its minority shareholders generally and stakeholders. They should approve such transactions only when such clear proof is presented. A committee of the board (or supervisory board), whether it is called audit committee, risk management committee, credit committee or other, can be useful for this purpose as far as it comprises independent directors and those who have expertise in bank finance. Moreover, banks are encouraged to institute and consistently apply internal rules restricting or prohibiting indemnification to officers if they breach relevant rules and are involved in related party transactions.

28. In addition to the measures mentioned above, **another option can be an outright banning of certain types of related party transactions.** This may include a ban on personal lending to the board members, senior management, controlling shareholders, and their close relatives, possibly with exceptions for some standardised lending such as housing loans to employees on market terms. This simple option would excel in its enforceability compared with other complicated rules that are more easily circumvented.

Chapter 3: Clear lines of responsibilities and accountability

This chapter relates to Principle 3 of the Basel CG Guidance and its annotations: "*The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.*"

29. It is important for the boards (or supervisory boards) to clearly define the authority and key responsibilities for themselves, senior management (including management boards) and others. Unspecified lines of accountability or confusing, multiple lines of responsibility may create a vacuum in which nobody is fully in charge. In order to avoid such a risk, **the boards (or supervisory boards) ought to have overall and ultimate responsibility for monitoring managerial performance[30], and thus, they should hold supervisory powers over senior management (including management boards).**

30. In some Eurasian countries with two-tier board structure, the members of management boards are appointed at general meeting of shareholders. Although this might provide shareholders with strong power, the question here is, can people (supervisory boards) effectively control/monitor others (management boards) without having any influence over their appointment or removal?[31] Arguably, this is why, in many OECD member countries that adopt two-tier boards, the supervisory boards appoint and remove (or propose, at general shareholders meetings, the appointment and removal of) the members of management board. As far as banking – a highly technical and complex business – is concerned, the supervisory boards composed of experienced individuals with appropriate expertise would usually be in a better position to oversee the management boards than the shareholders meeting and, thus, they should be granted the relevant powers. **Even if laws provide shareholders with the power of appointment/removal, the supervisory boards should propose**

[30] On the other hand, the boards (or supervisory boards) should refrain from micro-managing or intervening in the bank's day-to-day operations.

[31] In some other countries that adopt similar frameworks (e.g. Indonesia), the supervisory boards are said to have difficulties in effectively controlling the management boards due to their lack of power in relation to the appointment.

such an appointment/removal at general shareholders meeting. Banking supervisors should ensure that such a business practice prevails in banking industry.

31. On the other hand, as the Basel CG Guideline states, senior management (or the management board) is responsible for delegating duties to the staff and establishing a management structure that promotes accountability[32]. Senior management (or the management board) has the obligation to oversee the exercise of such delegated responsibility, and the board (or supervisory board) should ensure this.

[32] For instance, it is not appropriate that the board (or supervisory board) approves the job descriptions for *all* positions within the bank.

Chapter 4: Oversight by senior management and internal control functions

This chapter relates to Principle 4 of the Basel CG Guidance and its annotations: "*The board should ensure that there is appropriate oversight by senior management consistent with board policy.*"

32. Internal control is a process, effected by the board, senior management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories[33]: (i) effectiveness and efficiency of operations (performance objectives), (ii) reliability and timeliness of financial and non-financial reporting (information objectives), and (iii) compliance with applicable laws and regulations (compliance objectives). In varying degrees, internal control is the responsibility of everyone in banks.

33. Internal control is said to have been started as a mechanism for reducing instances of fraud, misappropriation and errors. However, it has become more extensive, addressing all the various risks faced by corporations. An effective internal control system for banks – since they are in the business of risk-taking – requires that *"the material risks that could adversely affect the achievement of the bank's goals are being recognised and continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organisation (that is, credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks*[34]*."*

34. Effective internal controls will be achieved when there is a bank culture, established by the boards and senior management, that emphasises and demonstrates to all levels of personnel the importance of internal controls. In addition to evaluations[35] made

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[33] Basel Committee, *Framework for Internal Control Systems in Banking Organisations* . Also see relevant works by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

[34] Basel Committee, *Framework for Internal Control Systems in Banking Organisations* .

[35] The internal auditors' evaluation of the effectiveness of internal controls will be discussed further in the next chapter.

by internal auditors (and often by external auditors), **banks should continuously monitor and evaluate the effectiveness of their own internal controls.** It is the responsibility of senior management to establish and improve banks' internal control systems based on these evaluations. **The boards (or supervisory boards) should guide senior management and ensure that they properly establish, implement, monitor and evaluate the effectiveness of, and constantly improve, the internal controls.** The Basel Committee's *Framework for Internal Control Systems in Banking Organisations* provides valuable suggestions not only for banks on how to establish, implement and improve their internal controls but also for banking supervisors on how to evaluate the effectiveness of banks' internal controls.

35. One of the key issues that internal controls should address is checks and balances, or the "four eyes principle" (i.e. segregation of duties, cross-checking, dual control of assets and double signatures). Task Force members point out that the true value of the *four eyes principle* may not be widely understood across banks in the Eurasian region. Control activities tend to be regarded as something redundant or in addition to the daily activities of the bank and are often seen as less important. However, the control activities would work most effectively and thus enable quick responses to changing conditions and avoid unnecessary costs when they are viewed by management and other employees as an integral part of the daily operations. **The boards and senior management should nurture a bank culture in which control activities such as the implementation of the *four eyes principle* are regarded as an integral part of daily operations.**

Chapter 5: Internal audit and external auditors

This chapter relates to Principle 5 of the Basel CG Guidance and its annotations: "*The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.*"

Internal Audit

36. Internal audit is part of the ongoing monitoring of the bank's system of internal controls[36]. There are different types of internal audits including, but not limited to, financial audits, compliance audits and operational audits. **The internal audit function ought to have appropriate status within the bank to ensure that senior management reacts to and acts upon its recommendations.** It should have a direct reporting line to the board (or supervisory board) or the board audit committee. Internal auditors should be suitably trained and have relevant experience to understand and evaluate the business they are auditing. The Basel Committee's guidance, *Internal Audit in Banks and the Supervisor's Relationship with Auditors*, provides useful insight on the subject.

37. The internal audit function in some Eurasian countries often involves the participation of *Revision Commissions* that are either given direct responsibility for the internal audit function or instruct the internal audit units/divisions/departments. They are separate bodies from the boards or senior management. Their members are appointed at general shareholders meetings. Although theoretically such a framework may be expected to support or enhance the independence of the internal audit function,

[36] The Basel Committee's guidance, "*Internal Audit in Banks and the Supervisor's Relationship with Auditors*" quotes the definition of internal audit developed by the Institute of Internal Auditors (IIA): "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

examples in some countries in other parts of the world[37] show that this structure often presents some difficulties. The Task Force recommends that national policy makers and regulators in jurisdictions that have *Revision Commissions* assess the effectiveness of this system in banks.[38] If they do not seem to be functioning effectively, the option of removing them from any legislation, or, at least, repealing the mandatory requirement to establish them is strongly recommended. Moreover, the Task Force believes that *Revision Commissions* cannot substitute for independent audit committees of the bank's board, the establishment of which is now internationally recommended. The international best practice shows the audit committees play a wider role (as shown in paragraph 19) than *Revision Commissions*. The audit committees, through mandatory inclusion of independent directors, for instance, are usually designed to be independent from management and controlling shareholders. More importantly, they are board committees: they belong to the boards (or supervisory boards) that monitor, control and guide senior management. **Reflecting the global trend in which the role and responsibility of the boards are increasingly highlighted and enhanced, abolishing *Revision Commissions* by shifting their functions to the board audit committees should be considered as one of the policy options.**

External Audit

38. Qualified and independent external auditors are expected to play an important role in helping ensure sound corporate governance. There has been a lot of discussion

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[37] For example, statutory corporate bodies that play similar roles in Korea have been criticised as being just formalities that do not have the necessary power in reality. In addition, it is often said to have been difficult in practice to figure out which organs, the bodies or the boards, are responsible for certain roles. Korea has recently revised its company law; banks or large companies are no longer allowed to have such bodies and instead they are legally required to establish board audit committees, which provide the boards with more integrated powers. There have also been criticisms in Japan about the effectiveness of similar bodies (*Kansayaku*) that Japan's company law had traditionally required for more than a hundred years. The company law in its recent revision finally made it optional for large companies to keep the bodies or abolish them and instead establish board audit committees.

[38] For instance, there seem to be a certain risk in which *"Revision Commissions"* are single-mindedly focusing on minor errors, unable to tackle bigger problems.

around the world recently in terms of their independence and effectiveness which is a precondition for any enlarged roles for external auditors. National standards for auditor independence should express specifically the need to ensure appropriate rotation of the audit engagement team so that senior members of the external audit firm do not remain in key decision-making positions for an extended period. Moreover, conflicts of interest need to be minimised by limiting the non-audit work they may undertake for their client companies. It is increasingly recognised that the legal framework should provide for proportionate, effective and dissuasive sanctions, penalties and/or liabilities for external auditors who fail to perform their audit functions with due professional care.

39. In many respects, the banking supervisor and the bank's external auditor have complementary concerns regarding the same matters, though the focus of their concerns is different. Bank boards (or supervisory boards) as well as banking supervisors ought to have sufficient opportunity to freely exchange views with banks' external auditors. For this purpose, banking laws should provide the legal basis on which banking supervisors are entitled to receive information from external auditors. **While taking into account the necessity to safeguard the normal relationship between banks and their external auditors, such external auditors should be required to report to the banking supervisors when they detect crimes or other significant breaches of laws[39][40].** Laws should provide statutory immunity in which external auditors cannot be held liable for information disclosed to banking supervisors. Furthermore, as stipulated in the Core Principles Methodology[41], it is recommended that the banking supervisors have the statutory power to reject and rescind the appointment of a bank's external auditor if the auditor (1) is deemed to have inadequate expertise or independence or (2) is not subject to or does not follow established professional standards.

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[39] Except in such exceptional circumstances, meetings between external auditors and banking supervisors should be attended by the representatives of the bank.

[40] The paper jointly developed by the Basel Committee and the International Auditing Practices Committee (IAPC), *The Relationships Between banking Supervisors and Banks' External Auditors* provides better understanding on this point. This paper is also known as IAPS1004 (International Auditing Practice Statement 1004) (http://www.bis.org/publ/bcbs87.htm)

[41] Essential criteria 6, Principle 22.

40. The external audit of banks increasingly needs special expertise as the banking business becomes more complex. Some Eurasian countries face difficulties in relation to this; there are only a few professional accountants with expertise in banking and the compensation for them is often too high especially for smaller banks. **Banking supervisors, capital market authorities, other governmental bodies, if any, in charge of professional accountants, and associations of accountants should work together to foster the development of professional accountants with special expertise in banking. The banking supervisors, at the same time, should have sufficient expertise in accounting and auditing, and for this purpose a training budget and program that provide regular training opportunities for their staff should be secured.**

Chapter 6: Compensation

This chapter relates to Principle 6 of the Basel CG Guidance and its annotations: "*The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.*"

41. An extraordinarily low level of remuneration of board members is no more desirable than an extraordinarily high level, although the latter tends to preoccupy much public debate. This should be particularly underlined for bank boards in countries where there is a tradition in which serving as board members is often an honorary job or a kind of social contribution. Banks need boards that can effectively perform their jobs backed by professionalism and board members should be sufficiently remunerated in accordance with the responsibilities they are expected to fulfill. Low remuneration may prevent banks from attracting qualified people or could tempt board members to obtain financial gain wrongly. **Zero or extraordinarily low remuneration of a bank board (or supervisory board) is never good but would rather indicate that the board may not be functioning very well.**

42. For countries where there are neither prevailing market rates nor accumulated business practices in terms of remuneration – in some Eurasian countries, for instance, board (or supervisory board) members have traditionally served without pay – **banking supervisors, banking industry associations or others may need to develop guidance on this.** In so doing, the Basel CG guidance[42] together with the OECD Principles[43] would serve as reference points. Based on such guidance, individual banks in turn should be encouraged to develop and publicly disclose a remuneration policy covering key executives and board members. The remuneration policy should specify how it aligns remuneration with the long term interest of the bank.

[42] Annotations to Principle 6

[43] Annotations to Principle VI.D.4

Chapter 7: Transparency and disclosure of information in terms of corporate governance

This chapter relates to Principle 7 of the Basel CG Guidance and its annotations: "*The bank should be governed in a transparent manner.*"

43. The third pillar of Basel II focuses on regulations that require accurate information disclosure and facilitate market oversight and discipline of banks. Recent research[44] based on the databases of more than 150 countries shows that governments which implement and enforce policies that hold bank board members responsible for the provision of reliable and timely information tend to produce better-functioning banks. Appropriate public disclosure by banks facilitates market discipline and sound corporate governance[45].

44. The Roundtable Comparative Report recommends that "convergence with international standards and practices for accounting, audit and non-financial disclosure should continue to be a top priority"[46]. **National laws/regulations/rules should require banks, whether listed or not, to comply with high quality accounting and disclosure standards consistent with internationally accepted standards[47].** In addition, banks should have their financial statements audited by an external auditor in

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[44] Barth, J., Caprio, G. and Levine, R. (2006), *Rethinking Bank Regulation*, Cambridge University Press, New York.

[45] With respect to disclosures by banking supervisors, on the other hand, a notable example of the efforts to improve them would be the *CEBS Guidelines on Supervisory Disclosure*. Responding to the EU Capital Requirements Directive that requires EU supervisors to make disclosures that allow meaningful comparisons of supervisory rules and practices across Europe, CEBS (Committee of European Banking Supervisors) has developed these guidelines. (http://www.c-ebs.org/pdfs/GL05.pdf)

[46] Roundtable Comparative Report, p.10

[47] A typical example of the internationally accepted standards would be *International Financial Reporting Standards (IFRS)* promulgated by the International Accounting Standards Board (IASB).

accordance with high quality internationally accepted auditing practices and standards[48].

45. While the Basel Committee's *Enhancing Bank Transparency*[49] provides guidance in terms of banks' public disclosure in general, the Basel CG Guidance lists key information specifically related to bank governance that should be publicly disclosed. Among the list, one of the most important information disclosures for some Eurasian banks would be regarding ownership structure (e.g. major share ownership and voting rights, beneficial owners, major shareholder participation on the board or in senior management positions). An opaque ownership structure poses a significant risk on the depositors, other stakeholders and minority shareholders. Particularly for enforcement purpose, and to identify potential conflicts of interest, **information about record ownership has to be complemented with information about beneficial ownership (ultimate owner).** Where information about beneficial owners is not known to the bank, the regulatory system should ensure that such information can be obtainable at least by regulatory and enforcement agencies and/or through the judicial process[50].

46. Concerning compliance with disclosure requirements by listed banks, **the Task Force would like to stress the importance of co-operation between banking supervisors and capital market authorities (i.e. securities regulators and stock exchanges).** Even if the primary authority for ensuring proper disclosure of banks rests with banking supervisors, capital market authorities are not exempt from their responsibilities to oversee and enforce standards for accounting, audit, and non-financial disclosure. In some exceptional cases, public disclosure of particular information of a bank (or of an ailing bank, especially) may involve the risk of triggering a run on the bank and may eventually lead to even greater systemic risk in

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[48] A typical example would be *International Standards of Auditing (ISA)* promulgated by the International Federation of Accountants (IFAC).

[49] http://www.bis.org/publ/bcbs41.htm

[50] The OECD template *Options for Obtaining Beneficial Ownership and Control Information* can serve as a useful self-assessment tool for countries that wish to ensure necessary access to information about beneficial ownership. (http://www.oecd.org/dataoecd/50/40/1961539.pdf)

an economy. At the same time, however, such a risk should neither be overstated nor used as a pretext by banks that do not understand the value of public disclosure for their reluctance to disclose necessary information. Problems regarding disclosure by an individual listed bank identified either by banking supervisors or capital market authorities should be shared by both organisations in due course – while taking into account the possible risk mentioned above – for possible corrective actions and sanctions/penalties according to relevant laws/regulations. Furthermore, while these organisations would naturally impose different disclosure requirements because of the differences in their objectives, they should closely coordinate in order to avoid irrational disparities in their requirements that impose an unnecessary burden on banks.

Chapter 8: Corporate governance of state-owned/controlled commercial banks (SOCBs)

47. While a few countries in Eurasia have virtually no state-owned/controlled commercial banks (SOCBs[51]), in other Eurasian countries SOCBs occupy a relatively high proportion of total bank assets. While some of the governance challenges that SOCBs face are similar to those faced by other banks, SOCBs also face some governance challenges that either are unique or are more acute than those faced by private sector banks. For instance, SOCBs are often protected, whether explicitly or not, from bankruptcy, competition and takeover – the threats that would otherwise have disciplined management behaviour. SOCBs may suffer just as much from undue hands-on or politically motivated ownership interference as from totally passive ownership by the state.

48. Based on the best practices among its member countries and the OECD Principles, the OECD has developed the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* ("SOE Guidelines")[52], which apply to banks as well as other types of firms. The Task Force agrees with the key recommendations of the SOE Guidelines such as: (1) the state as an owner should ensure that SOEs have professional and effective boards (or supervisory boards) that can exercise objective, independent judgment, and (2) the state should fully utilise the boards (or supervisory boards) as overseers of SOEs' activities while refraining from directly intervening in the day-to-day operations of SOEs.

49. The state should not be a passive, indifferent owner that simply acts as a rubber stamp. **It should develop and make public an ownership policy that defines the overall**

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[51] The term SOCBs here refers to commercial banks where the state has significant control, through full, majority, or significant minority ownership. State shareholding can either be direct or indirect through other entities. They can either be listed or non-listed, but do not include what is often called "development banks" or "policy lending banks" that primarily serve as policy tools through policy oriented lending.

[52] http://www.oecd.org/document/33/0,2340,en_2649_34847_34046561_1_1_1_1,00.html

objectives of state ownership, the state's role in the corporate governance of SOCBs, and how it will implement its ownership policy. The objectives stipulated in the ownership policy may include the pursuit of profitability in the form of specific targets (e.g. the rate of return or dividend policy) but may also include trade-offs, for instance, between shareholder value and public service. The state should therefore indicate its priorities in its ownership objectives.

50. The state should refrain from unduly intervening in SOCBs' management. Once the state has set the objectives for SOCBs, it should let SOCBs' boards exercise their responsibilities and it should respect their independence. The objectives set by the state cannot be achieved efficiently by the intervention of government in day-to-day management of SOCBs[53]. For instance, state officials should not interfere in any specific lending decision[54]of SOCBs even if the SOCBs are specifically dedicated to implementing certain state-designed lending policies (e.g. agricultural finance). Instead**, the state should properly use and respect the legal corporate structure of SOCBs, and thus should take advantage of the corporate form** which is presumably one reason for separating the banks from the state administration in the first place. **The boards of SOCBs should act professionally and include a sufficient number of "independent" members** so that they are able to make decisions independent of the state's possible (politically driven) day-to-day intervention, while effectively monitoring the management in accordance with the objectives set by the state in its capacity as a controlling shareholder.

51. **SOCBs, whether listed or not, should be subject to an annual, independent external audit in addition to the specific state audit which is often designed**

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[53] It would even be harmful if such intervention is not disclosed and, consequently, neither the state officials nor the boards and senior management of SOCBs are accountable for the results of the intervention.

[54] With regard to the state's interference in lending decisions, not just those of SOCBs but also of banks in general, the Basel Core Principles state in paragraph 14: *"Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives. In these circumstances, it is important that, if guarantees are provided for such lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform."*

principally to monitor public funds and the use of budget resources. The state should maintain a continuing dialogue with the external auditors of SOCBs so long as this is compatible with relevant laws.

52. The Task Force welcomes the general trend towards privatisation of SOCBs in Eurasia and firmly supports such decisions made by national authorities. Generally speaking, privatisation can bring market discipline and thus improve corporate governance. It should be noted that, at the same time, efforts at improving corporate governance of SOCBs can be made whether or not there is a specific plan for privatisation in the future. Contrary to the often prevailing understanding, it is possible for SOEs to have better corporate governance standards than private sector companies on average. **The state as an owner should try to ensure that the best corporate governance practices available in a jurisdiction are adopted and implemented for SOCBs.** By doing so, SOCBs will function as role models of sound corporate governance and thus may create market pressure on other banks to adopt better corporate governance.

Chapter 9: Banks' monitoring of the corporate governance practices of their corporate borrowers

53. Regardless of countries' efforts to develop sound capital markets, banks in some Eurasian countries play a significant financial role and often wield significant power over borrowing companies. The question, then, is what roles are banks expected to play (or not to play) in relation to the corporate governance of their corporate borrowers?

54. First, banks should recognise that it is in the best interests of the banks themselves to assess and monitor, *ex-ante* and *ex-post*, the corporate governance structures and practices of their corporate borrowers to the extent that those structures or practices affect the borrowers' creditworthiness. Since certain poor corporate governance practices on the part of borrowers are likely to affect their overall creditworthiness, both (i) the assessment of the corporate governance structures and practices of companies to which banks are considering whether to provide loans, and (ii) the monitoring of them until the loans are repaid, should form an important part of proper risk management[55]. **Banking supervisors in Eurasia should therefore encourage banks to assess and monitor the quality of the corporate governance of their debtor companies as a critical part of their ongoing credit risk management.** Second, considering that the pressure through securities markets to raise national standards of corporate governance is insufficient in some Eurasian countries (because such markets may not be functioning particularly well), the assessment and monitoring function by banks as a part of their risk management may deserve policy makers' attention as one of the more effective policy tools, if not a primary one, for improving corporate governance practices in a country[56].

55. On the other hand, banks obviously are not the only stakeholders interested in the operations of their borrowing companies. Banks' interests do not necessarily

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55 The level of the assessment and monitoring can vary depending on the amount of exposure to the corporate borrower.

56 This suggestion does not mean that government can pass on its role to banks to improve national corporate governance standards.

converge with those of others and consequently they cannot be expected to represent the interests of shareholders or other stakeholders. To avoid conflicts of interest and to contribute effectively to the enhancement of borrowers' corporate governance, banks should play a transparent role and the governance-related requirements they may impose on their borrowers should be clearly stated in advance. Consistent with the Basel Committee principles for the management of credit risks, **where conditions relating to corporate governance are considered to be necessary, they should be adequately documented and included in covenants.** For instance, such a covenant could, depending on the size of the corporate borrowers, stipulate conditions regarding the corporate governance structure of the borrowers, and a deviation from this may lead to the bank's withdrawal of credit. It is desirable that these conditions are drafted in a way that a violation thereof can be easily identified (e.g. maintaining a minimum ratio of independent, non-executive directors or separating the role of chairman and CEO) in order to prevent arbitrary decisions, improve potential enforcement, and avoid unnecessary dispute. The covenant should include the obligation for corporate borrowers to report deviation to the bank, which would in turn reduce the burden of monitoring by the bank.

Chapter 10: The role of supervisors and the next steps

This chapter relates to section IV of the Basel CG Guidance: “*The role of supervisors*”.

56. The Basel CG Guidance sets forth six principles that can assist banking supervisors in assessing corporate governance of banks. The Task Force considers that these principles include important suggestions which are applicable to the Eurasian region. The followings are further considerations based on these principles.

57. Although the Task Force believes more effective banking supervision is increasingly needed in the region, banking supervision, especially direct regulation by which banking supervisors try to prevent and correct the wrongdoings of banks, is by no means a panacea. It is impossible for banking supervisors, whose human/financial resources are limited, to check every action by banks in a country. **Banking supervisors should therefore put more emphasis on promoting good corporate governance of banks in which banks, under the guidance and oversight of their boards (or supervisory boards), would naturally implement sound banking practice.** Banking supervisors should determine whether the bank has adopted and indeed effectively implemented sound corporate governance policies. They should also assess the quality of banks’ internal control functions, internal audit and external audit.

58. While ‘hard law’ (i.e. laws and regulations) is essential for ordinary banking supervision, corporate governance objectives are often formulated in the form of ‘soft law’ – namely, voluntary corporate governance codes that do not have the status of law/regulation or direct binding force. Among OECD member countries, virtually none lays down full and detailed corporate governance provisions in the form of laws/regulations and **it is recommended that Eurasian countries also seek an appropriate combination of hard law and soft law.** It is true that some essential elements of corporate governance should be mandated and enforced in the form of hard law, but more advanced standards, for instance, can be set in other forms such as national corporate governance codes. Such codes can be revised more easily on a timely basis and allow experimentation and innovation. They also enable banks to tailor governance structures and practices to their unique circumstances.

59. These codes are often implemented on what is called a "comply or explain" basis in which firms that do not comply with the requirements have to clearly explain the reasons for non-compliance to their shareholders[57]. **The "comply or explain" approach is strongly recommended as international best practice.** Implementation of the "comply or explain" approach, however, varies from country to country: in other words, there are many ways on how to make (or induce) companies fulfill the "comply or explain" requirements[58]. For instance, the codes can be mere recommendations. Or, they can be listing requirements of a stock exchange. Company laws, as in several European countries, may explicitly refer to certain codes developed by private bodies with the support of governments. In some countries (e.g. Turkey), the securities regulator has developed a "comply or explain" corporate governance code. In some Eurasian countries where market forces or shareholders' activism is not yet so strong as to lead banks into fulfilling the "comply or explain" requirements, the first approach (i.e. purely voluntary recommendation) may not be the best option.

60. The Basel CG Guidance in section IV makes it clear that banking supervisors should provide guidance to banks on sound corporate governance and pro-active practices that should be in place. It would be useful to develop the national corporate governance codes for banks. If there are already general corporate governance codes applicable to all companies, such codes for banks would supplement the general codes. If there are no such general codes, developing the governance codes for the advanced industry (i.e. banking) may open up discussion and provide model for future general governance codes. As evidenced by the fact that the Task Force includes both banking supervisors and capital market authorities, developing corporate governance codes for banks is indeed an inter-disciplinary issue across the areas of banking supervision and securities regulation as far as listed banks are involved. Acknowledging the unique features of corporate governance of banks and the necessity of harmonisation with existing rules applicable to non-financial listed companies, the Task Force recommends that **banking supervisors (or banking**

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[57] Experience in a number of countries suggests that even when "complying" with a code, companies should be expected to explain how this is being done.

[58] See Eddy Wymeersch. (2005), *Enforcement of Corporate Governance Codes*, ECGI Working Paper Series in Law.

industry associations, while exchanging views with banking supervisors) in Eurasia, in conjunction with securities regulators and stock exchanges (or institute of directors, when appropriate), should develop (making use of public consultation with market participants) and publicise a code of corporate governance for banks, in the form of a template on which banks should base the development of their own codes (i.e. individual banks' corporate governance codes).

Annex . Definition of independent directors

It is not easy to develop a well-balanced definition of independent directors for a country. Lax definitions would not contribute very much to ensure boards' objective judgment while excessively strict ones without a reality check would hamper the recruitment of appropriate individuals. A definition of a country should therefore fully reflect its own national condition. However, there still seem to exist some common elements across countries in the definitions of the independent directors. In fact, several multilateral organisations[59] have developed a report or recommendation in relation to the definition. Taking these into account, the Task Force has made an attempt to develop as an example, a proposed set of definitions of independent directors (a negative list) to which future efforts in Eurasian countries to seek appropriate definitions may want to refer. The numbers in [ ] below are suggested figures intended to serve only as a guide.

"Independent Director" means a director who is a person who:

(1) has not been a member of senior management (including the management board) of the bank or any of its associated companies for the previous [five] years.

(2) has not been an employee of the bank or any of its associated companies for the previous [five] years.

(3) has not received, directly or indirectly, any significant additional remuneration, compensation, allowance or donation other than directorship fees and/or reimbursement of costs associated with attending director' meetings from or on behalf of the bank or any of its associated companies for the previous [three] years.

(4) has no material business relationship (including lending or borrowing relationships) with the

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[59] In consultation with the OECD, a task force of IOSCO (International Organization of Securities Commissions) developed a report on board independence of listed companies. The European Commission has developed a recommendation on the role of non-executive or supervisory directors of listed companies. The International Finance Corporation (IFC) has also established its own definition that is applicable when the IFC finances companies.
(http://www.iosco.org/library/pubdocs/pdf/IOSCOPD238.pdf).
(http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf)

bank or any of its associated companies, either directly, or as a partner, major shareholder, director or senior employee of a body having such a relationship and has not had such a relationship for the previous [three] years.

(5) has not been a partner or employee of the present or former external auditor of the bank or any of its associated companies for the previous [three] years.

(6) is not, or does not in any way to represent, a significant shareholder of the bank.

(7) has not served on the board of the bank for more than [12] years.

(8) is not a close family member of a person referred to in (1) to (7) above.

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* The findings and opinions expressed in this policy brief are personal and do not necessarily reflect the views of the organisations the participants serve or their countries of origin. The job titles below indicate the positions they held when they initially join the Task Force.

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